



DIVISION OF
MARKET REGULATION

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

December 21, 2000

The Honorable John D. Dingell
Ranking Member
Committee on Commerce
2322 Rayburn House Office Building
Washington, D.C. 20515

Dear Congressman Dingell:

Chairman Levitt has asked me to respond to your February 23 letter to Attorney General Janet Reno, NASD Regulation President Mary Schapiro, and him requesting that we provide you with year-end updates on efforts to address allegations of "spoofing" or "phantom quotes" in Nasdaq securities. As you know, these schemes involve attempts by parties to manipulate share prices by creating fictitious quotations of only a few seconds duration in hopes that so-called "momentum" traders will exacerbate short-term price swings. I am pleased to be able to report that our oversight programs indicate that the NASD has made substantial progress in enhancing systems capacity and surveillance programs to respond to these problems. Moreover, the Commission's investigations into several instances of possible spoofing are continuing and recent enforcement referrals from the NASD may result in additional investigations by the Commission over the coming months.

As Chairman Levitt indicated in his letter to you dated February 5, many of the instances of rapid order cancellations and quotation changes in volatile Nasdaq stocks in late 1999 and early 2000 appear to have reflected capacity limitations in Nasdaq systems. When high levels of price volatility and heavy inflows of orders and quotation changes resulted in queuing on Nasdaq systems such as SelectNet, particularly at the beginning of the regular trading session, delays in price and trade reports may have caused some market participants to repeatedly cancel existing orders and enter revised orders as a precaution against receiving executions at unfavorable prices. These cancellations and resubmissions may have exacerbated backlogs in these systems, which in turn could have resulted in further cancellations and resubmissions that reinforced the cycle.

The Commission staff has been carefully monitoring Nasdaq's efforts to increase its system capacity to reduce queuing problems on SelectNet and other Nasdaq systems during peak periods. The Nasdaq staff indicates that, while individual firms that have not adequately upgraded their systems sometimes experience delays in trade reports, widespread problems have

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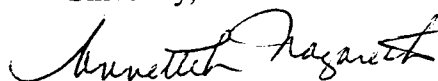
largely been addressed. Moreover, Nasdaq is currently implementing the SuperSoes System, which will further address potential system bottlenecks by modifying Nasdaq's Small Order Execution System to handle some of the order flow that had been overwhelming SelectNet. The Commission staff will continue to closely monitor Nasdaq's capacity enhancements.

The Commission staff has also held discussions with officials at NASD Regulation regarding their efforts to fine-tune surveillance programs to identify suspicious patterns of rapid quotation changes that result in short-term price swings in Nasdaq securities. In May, NASD Regulation implemented an experimental version of a new program in this area, and this program went into full production on September 18. While we cannot discuss the specific time and price-change parameters used by these surveillance enhancements in a letter that may become public, we can report that the spoofing surveillance program appears to be conceptually sound and reportedly has already produced several inquiries and investigations, some of which have been referred to the Commission's enforcement staff. Moreover, the NASD Regulation staff indicates that planned upgrades of the surveillance program over the coming months to link it directly with audit trail data from the OATS system will further enhance their efforts to identify and investigate suspicious quote activity.

In Chairman Levitt's February 5th letter, he noted that several investigations into instances of possible spoofing activities were underway. These investigations are proceeding, and the recent enforcement referrals from NASD Regulation appear to be promising. As you know, Commission policy precludes my discussing in detail matters that may be the subject of a Commission investigation or potential enforcement action. If ongoing inquiries provide evidence of manipulative phantom quotes, the staff will recommend that the Commission authorize enforcement actions against the perpetrators. As always, if criminal violations of the securities laws were indicated, these matters would be referred to the Department of Justice for consideration.

I hope that you will find this information to be useful. The Commission shares your commitment to ensuring that evolving market structures do not provide unchecked opportunities to disadvantage investors or compromise market integrity.

Sincerely,

A handwritten signature in dark ink, appearing to read "Annette L. Nazareth". The signature is fluid and cursive, with the first name being the most prominent.

Annette L. Nazareth
Director